Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of

A La Carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems	)	MB Docket No. 04-207

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As the Commission begins its inquiry into a la carte regulation of multichannel video programming distributors ("MVPDs"), it is vital that one over-arching principle not be forgotten: The whole is often greater than the sum of its parts. And in the case of MVPDs and their service tiers or product bundles, the whole is *much* greater—and of much greater value to consumers—than the sum of its individual parts. Doing away with this system would have potentially devastating impacts for companies and consumers alike.

I. <u>The Benefits of Bundling</u>

It would not be an exaggeration to claim that the modern MVPD industry largely owes its success to the practice of bundling. As is the case with every high fixed cost / low marginal cost industry, MVPDs were stuck finding a sensible way to amortize their significant up-front costs of doing business. Various price discrimination schemes were certainly one option the industry could have adopted in an effort to recoup their initial investments, but, ultimately, MVPDs settle on a bundling arrangement commonly known as "tiering."

It is easy for policymakers and industry analysts to second guess the wisdom of this decision and imagine what the MVPD world might have looked like had another model been chosen, but the important issue not to lose sight of here is that tiering worked. MVPDs survived and thrived while consumers gained access to an ever-expanding array of video programming options. By any conceivable statistical measure, citizens today have access to more video outlets and options than at any time in history. And the industry has invested tens of billions in infrastructure upgrades to provide continuous service improvements and line-of-business expansions. This is a great capitalist success story not to be taken lightly or casually disposed of by regulatory fiat.

Thus, this debate really comes down to the question of whether government should pre-empt an industry's preferred (and quite successful) business model. But it also remains unclear why bundling should be prohibited in this sector while it is simultaneously regarded as an accepted business practice in so many other American industries. Indeed, bundles are ubiquitous throughout our economy. Every "two-for-one" sale is a bundle. So are 6-packs of beer. Right shoes are always sold with the left, and shoestrings are bundled into the deal too. Automobiles come bundled with tires, radios, spark plugs and so on, even though all those things could potentially be sold separately. And the newspaper industry offers up one of America's oldest and most successful bundling business models since readers are sold—at a fixed price—several unrelated sections of content on a "take it or leave it" basis. And yet every day in every town in America, millions of citizens gladly accept that deal. So bundles, and bundling, are all around us.

Why, then, should the Commission or Congress get involved in determining whether bundling is the best business model for MVPDs and their consumers? If this task is best left to private actors and the forces of supply and demand for every other sector of the American economy, why shouldn't it also be left to market forces in the video programming marketplace?

Market power certainly cannot be cited as justification for government intervention. With major telephone companies investing billions in new "fiber to the curb" networks[1] and DBS providers still engaged in a fiercely competitive duel with cable operators,[2] what purpose is served by adopting a la carte mandates for this sector? Vigorous facilities-based competition is the ultimate consumer safeguard, and it holds out the hope the there will be even more market experimentation with alternative video delivery models in the future. As the recent launch of U.S. Digital Television illustrates, there is a market for alternative video delivery models that could potentially upend the way this industry operates in the near future.[3] For $19.95 a month, USDTV offers a handful of the most popular channels on cable or satellite networks today, plus high definition programming.

Indeed, as this competitive drama unfolds, an a la carte mandate might skew marketplace outcomes in highly unnatural ways or unfairly tip the competitive balance in one direction or another. There may well come a day when it is more feasible for MVPDs to offer the equivalent of a fully unbundled, "tier-less" buffet of video programming, but we are not there yet. And when that day arrives, the industry, not the government, should be in charge of throwing the switch and converting to this new business model.

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[1] Reinhardt Krause, "SBC Will Square Off Against Cable Rivals in Video, TV Services," *Investor's Business Daily*, June 23, 2004, p. A4.
[2] Reinhardt Krause, "Competition in Pay-TV Market Spooks Satellite, Cable Investors," *Investor's Business Daily*, May 10, 2004, p. A6.
[3] Ellen Sheng, "U.S. Digital Hopes Less Is More For Viewers of Its Pay-TV Service," *The Wall Street Journal*, May 18, 2004; Ian Austin, "Local Broadcasters Offer Cheaper Premium Services," *The New York Times*, May 3, 2004.

II. <u>Preserving Media Diversity & Choice</u>

How might an a la carte regulatory regime be administered, and what might be the potential costs and benefits of such an arrangement? The a la carte cost-benefit analysis is not easy to compute, but it comes down ultimately to the following equation: Will the supposed short-term benefits that accrue to consumers from gaining added choice over channel purchases outweigh the potential long-term loss of several individual channels, which either prove to be less popular with the viewing public or unable to stand on their own without being bundled alongside other channels? Are policymakers prepared to roll the dice on this risky gamble?

What is most ironic about the proposals to impose a la carte mandates is that they follow so closely on the heels of the heated debate over media ownership reform.[4] Of central concern in that debate was the question of whether our modern media marketplace was diverse enough and whether consumers had adequate news and entertainment choices at their disposal.

A la carte regulation would likely curtail the overall amount of niche or specialty programming on MVPD networks. The current tiering approach almost certainly keeps many smaller, specialized channels afloat. In fact, as a contractual matter, many independent video programmers refuse to sell their channels to MVPDs unless they are included in a specific tier or along with another popular channel they produce. [More on

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[4] Federal Communications Commission, "In the Matter of 2002 Biennial Regulatory Review – Review of the Commission's Broadcast Ownership Rules and Other Rules Adopted Pursuant to Section 202 of the Telecommunications Act of 1996," FCC 03-127, June 2, 2003, available at: http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-03-127A1.pdf

this below]. An a la carte regulatory mandate might need to nullify existing contracts in order to offer consumers unrestricted channel choice immediately.

But doing so would likely cut back the overall range of consumer choices in the long term. And how would consumers even find new niche channels in an a la carte environment? As an important recent General Accounting Report (GAO) report on this issue noted, “subscribers place value in having the opportunity to occasionally watch networks they typically do not watch.”[5] In other words, viewers place a high value on “channel surfing” since it allows them to sample new channels and programs. But a la carte regulations would discourage that process and suppress the development of new niche programming options by eliminating the ability of consumers to sample a wide variety of new channels and programs. This is just one way in which the whole proves to be greater than the sum of its parts.

III. <u>The Importance of Pricing Flexibility</u>

This debate is about more than bundling and how channels are packaged and offered to the public; it is also about pricing and pricing flexibility. On one level, there are pricing issues associated with program carriage or retransmission rights. Complex deals are frequently hammered out between MVPDs and many independent programmers that impose downstream costs which consumers must ultimately absorb. Certain channels

[5] U.S. General Accounting Office, “Telecommunications: Issues Related to Competition and Subscriber Rates in the Cable Television Industry,” October 2003, p. 37, available at: http://www.gao.gov/new.items/d048.pdf.

are bundled along with other, more popular channels at the request of programmers, who can use their best channels as leverage in cutting such deals.

While the negotiations between MVPDs and unaffiliated programmers over carriage and compensation rights can be very heated, messy affairs, this is an example of a well-functioning and vigorously competitive market at work. In the end, both parties make concessions and the net result of these negotiations is that consumers gain access to more channels. Thanks to this process, the costs of individual (and sometimes less popular) channels get spread across many other channels, which also helps pull in more advertising revenue.

Here is where it becomes clear just how much more valuable the whole is than the individual parts. Without the ability to structure bundles in such a fashion it is unlikely advertisers would find the business proposition as attractive from their perspective. If a la carte eliminates these aggregated bundles, it also eliminates the incentive for advertisers to play their part in helping keep overall rates down since they will not likely be as willing to place ads on MVPDs without the guaranteed broader distribution they currently receive. This would obviously hurt many smaller, niche channels, but it would also drive up costs for many popular channels found in most basic tiers, such as ESPN, MTV, TBS, the Disney Channel, and Fox News. A recent report by Bear Sterns argued that, depending on the "take-rate" for these channels (i.e., how many consumers subscribe to them on an a la carte basis), the cost of each of these channels would rise by several dollars. This is because, "a la carte take-rates would be considerably lower than the current 100% distribution for most basic networks. And the lower the penetration, the lower the advertising revenue and the higher the affiliate fee necessary to recoup the lost distribution revenue."[6] Thus, Bear Stearns projects the following price increases for these five popular channels under an a la carte regime.

	Current Rate	**75% Take-Rate**	**50% Take-Rate**	**25% Take-Rate**
Disney Channel	$1.48	$1.97	$2.95	$5.90
ESPN	$3.78	$5.12	$7.79	$15.82
MTV	$0.43	$0.64	$1.06	$2.32
Fox News	$0.51	$0.70	$1.06	$2.17
TBS	$0.47	$0.69	$1.12	$2.42

Assuming an average consumer took at least these five popular channels and several other favorites, it quickly becomes evident that ordering several individual channels on an a la carte basis may end up costing just as much as buying an entire tier today.

The point here is that policymakers need to remember that there is actually another bundling process at work in addition to the one they seek to address with a la carte mandates, which would make regulation even more complicated than it appears on the surface. That is, independent programmers sometimes demand that MVPDs accept a bundle of their channels, and then MVPDs re-bundle those channels with still others to create a tier. This bundling of certain channels together by independent programmers is what keeps many niche channels and programs afloat and keeps new channels coming. As mentioned above, an a la carte mandate would upend these business dealings or arrangements and alter pricing structures for many channels. And many niche channels—assuming they don't disappear altogether—would likely experience significant price

[6] Raymond Lee Katz, Katie Manglis, and Gloria Radeff, "A La Smart?" Bear Stearns *Equity Research*, March 29, 2004, p. 4, *available at* http://www.ncta.com/a_la_carte/bear_stearns_a_la_smart.pdf

hikes if unbundled from other programs that had previously cross-subsidized them. This explains why twenty female programming executives for niche cable channels such as *Lifetime, Oxygen,* the *Food Network*, the *National Geographic Channel*, *BET*, and many others, recently sent an open letter to members of Congress opposing a la carte mandates. These women executives warned that, "Government efforts to dictate how our programming is packaged or marketed would be bad for consumers because it would give them less choice and less diversity in programming, and it would increase the price they would pay for this inferior set of offerings…. Notably, it would substantially reduce audience reach and viewership, resulting in significant reductions in advertising revenue that would cause the demise of many existing cable program services and severely limit the creation of new ones."[7]

Will consumers be willing to absorb the per-channel price increases that will likely accompany the adoption of an a la carte rule? If not, will some sort of price control scheme be suggested as a method of keeping per-channel prices in check should large numbers of consumers rebel against price increases for their favorite specialty channels? If that is the case, then we will have essentially regressed a dozen years and be back in a world of Cable Act-like price regulation, which proved to be such an innovation and investment killer that Congress repealed the rules four years after the experiment began.[8]

[7] "An Open Letter to Congress From Concerned Women Programming Executives Opposing *A La Carte* Pricing of Consumers' Television Channel Choices," May 5, 2004, *available at* http://www.ncta.com/a_la_carte/open_letter_from_women_execs.pdf

[8] See: Thomas W. Hazlett, "Prices and Outputs Under Cable TV Reregulation," *Journal of Regulatory Economics*, Vol. 12, 1997, pp. 173-195, *available at* http://www.manhattan-institute.org/hazlett/rahazl6.pdf

To be clear, the new price control regime necessary in an a la carte world would be even more intrusive than the old system. At least when regulators were asked to establish price controls last time around they could do so for entire tiers of service. But the whole point of a la carte regulation is to obliterate tiers meaning that the only way to impose price controls is on a per-channel basis. The idea of the Commission establishing "fair" prices for literally hundreds of individual television channels is troubling. This will be a daunting, time-consuming task for the Commission and the impact of such a move on video programmers is equally disconcerting. If the history of price controls has taught us anything, it is that price regulation does not occur in a vacuum; it has a negative impact on many other variables, namely, the quality and quantity of the good or service in question. It is like a frustrating game of regulatory "Whack-a-Mole;" regulators put pressure on one variable, but another pops up for them to deal with. Prices can be capped, for example, but then the quantity of the good will fall, or its quality will be diminished. This explains why price control experiments always end in miserable failure.[9]

It is also important to take this pricing analysis to another level, and ask what the impact of an a la carte mandate might be on future broadband pricing or investment decisions. At root, MVPDs are all nothing more than big pipes or broadband service providers ("BSPs)" that compete against other broadband players. The provision of video programming is *already* part of a larger bundle of services that many BSPs provide.

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[9] See generally, Robert L. Schuettinger and Eamonn F. Butler, *Forty Centuries of Wage and Price Controls* (Washington, D.C.: The Heritage Foundation, 1979).

Indeed, technological convergence is a reality today as many cable operators now provide the long-elusive "triple play" of services: voice, video, and data connectivity.[10]

One of the most interesting debates that has taken place (mostly behind the scenes) in this industry in recent years involves the question of how access to broadband pipes should be priced in the future. Would a per-minute or per-bit pricing scheme help conserve pipe space, avoid congestion, and recover costs and enable BSPs to plow the savings into new capacity? Possibly, but nothing much has come of this debate, and no carrier has acted on such a plan for two reasons. First, broadband operators are probably concerned that such a move to employ a more complicated price discrimination regime might bring about unwanted regulatory attention. Second, and more importantly, cable and telco firms are keenly aware of the fact that the web-surfing public has come to view "all you can eat" buffet-style, flat-rate pricing for Internet access as a virtual inalienable right.[11] Broadband providers probably don't want to rock the boat too soon with more creative pricing schemes, but someday they may have to as bandwidth-intensive web sites and other applications start to eat up more and more pipe capacity.

Regardless, this raises the important question of whether or not broadband operators should have the right to price network access in this manner. Per-minute or per-

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[10] David Lieberman, "Comcast Forecasts Digital TV, PC, Phone Convergence," *USA Today,* July 1, 2004, p. 1B.

[11] See: Andrew Odlyzko, *Pricing and Architecture of the Internet: Historical Perspectives from Telecommunications and Transportation*, (unpublished manuscript, on file with the University of Minnesota Digital Technology Center), March 21, 2004, p. 27, *available at* http://www.dtc.umn.edu/~odlyzko/doc/pricing.architecture.pdf. ("Perhaps the most potent limitation on the proposed new architectures for the Internet, and the associated discriminatory practices, is posed by a range of factors deriving ultimately from behavioral economics. People react extremely negatively to price discrimination. They also dislike the bother of fine-grained pricing, and are willing to pay extra for simple prices, especially flat-rate ones.")

bit pricing might be one option some MVPDs experiment with, while others might adopt a hybrid tiering arrangement which offers some "basic" level of Internet access at a low flat-rate with scaled rates for progressively greater bandwidth or application usage.

In this environment, a la carte schemes might evolve naturally as a competitive response by some MVPDs to evolving market conditions. A carrier might employ a hybrid a la carte arrangement for video program services, with a secondary charge for data connectivity which could be flat-rate in character. Or perhaps all forms of access to the BSP's pipe will be priced at a flat rate, or perhaps it will be metered, or perhaps it will all somehow be a la carte in nature. The optimal pricing and packaging mix is impossible to determine. But changing market conditions will almost certainly create new pricing dynamics in the sector and perhaps even require BSPs / MVPDs to consider voluntarily unbundling all their services.[12]

Consider that, just five years ago, few in the recording industry would have likely imagined the day would soon come when they would have to voluntarily unbundle albums and sell each song individually for 99 cents. And yet that day has arrived thanks to the rise of file sharing and peer-to-peer (P2P) networks, which threaten traditional industry pricing schemes and business models. Even if the recording industry is

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[12] Anton Wahlman and Brian Coyne of the equity research firm Needham & Company argue that, contrary to popular opinion, the real value in broadband networks is the bandwidth itself, not the content that flows over it. High-speed connectivity, in their opinion, turns out to be the real "killer app," not content or applications. Arguing that consumers derive the most value out of a simple, high-speed on-ramp to the Net and other data networks, they come to the conclusion that "the dumb pipe is the only money pipe." That is, broadband operators who become fixated with adding numerous bells and whistles to their broadband package will ultimately miss the real value proposition consumers care about: a speedy and reliable Internet connection. Anton Wahlman & Brian Coyne, *The Dumb Pipe is the Only Money Pipe*, EQUITY RES. NOTE (Needham & Company, Inc., New York, N.Y.), Dec. 15, 2003, *available at* http://www.vonage.com/media/pdf/res_12_15_03.pdf.

successful in litigating many of these P2P providers or networks out of existence, traditional recording industry business models have probably forever been changed due to these recent developments as well as changing consumer expectations about how music is packaged and delivered. Could similar disruptive events be in store for MVPD providers? As broadband connectively expands and file sharing invades the video space, we could find out sooner than the industry hopes.[13]

The bottom line is that it should be left to private actors to determine which pricing schemes are utilized in the future to allocate scarce space on their broadband pipes / video programming networks. Lacking a crystal ball or a Nostradamus-like ability to predict the future, no one knows for sure which pricing schemes will work best. Policymakers need to provide network operators with the freedom to innovate and employ multiple pricing schemes and service models so that market experimentation can reveal which model most benefits society.

IV. A Monumental Consumer Hassle

A la carte would be nothing but a hassle for consumers, many of whom struggle to program their VCR clocks and rarely take advantage of V-Chip blocking technology or other content filters in their current televisions or set-top boxes. Let's face it, American consumers hate hassles and a la carte mandates would create the ultimate consumer hassle. Presumably, an a la carte mandate would require that MVPDs provide each

[13] For more discussion on this issue, see: Adam D. Thierer, "Pipe Dreams: Why 'Dumb Pipe' Models Make for Poor Public Policy," in *Free Ride: Deficiencies of the MCI 'Layers' Policy Model and the Need for Principles that Encourage Competition in the New IP World*, New Millennium Research Council, (forthcoming) June 2004.

household a channel checklist (either on paper, online, or over the phone) that would need to be filled out. How long will this take? In a 500-channel universe, how many hours will consumers need to spend on their computers, or on the phone with cable representatives?

Alternatively, technological upgrades would be necessary to make a la carte a reality. A new addressable converter box would need to be installed in each home to ensure that channel selections could be properly scrambled if they were not selected by the consumer. This could mean the end of cable-ready TV sets since everyone will need a set top box under an a la carte system, and that means higher costs for many households since most currently do not have such boxes. The GAO Report estimated that such set-top box upgrades could result in a monthly fee increase from $4.39 to $13.17 for a home that needs to add three addressable converter boxes to make a la carte a reality.[14]

It is impossible to calculate how much all this will cost, but the most important cost calculation may be the amount of time consumers will waste dealing with the effects of this new regulatory regime.

V. "Themed-Tiered" Programming Mandates: An Invitation to Censor

Some parties have also suggested that absent a full-blown a la carte mandate, government should break up existing tiers and create new bundles that offer consumers

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[14] U.S. General Accounting Office, "Telecommunications: Issues Related to Competition and Subscriber Rates in the Cable Television Industry," October 2003, p. 32, *available at* http://www.gao.gov/new.items/d048.pdf.

different types of programming options (perhaps over “mini-“ or “micro-tiers.”) In particular, some suggest that requiring MVPDs to offer “themed” tiers, such as a “family-friendly” tier, might be one way of expanding consumer choices or help “clean up” cable and satellite TV.

This is dangerous thinking. A themed-tier programming requirement potentially puts Congress or the Commission in the content regulation business with a vengeance. If MVPDs are required to offer the public a “family-friendly” tier of programming, it means someone must define what that term means. The “light touch” regulatory approach would simply mandate that MVPDs offer such a tier but then allow the interaction of operators, program suppliers and consumers determine what fell into that mix. But how long would it be before some consumers cried foul about one channel or another being thrown into that mix which they did not regard as being truly “family-friendly”?

Enough consumer complaints would likely produce calls for government assistance in defining this term of art. Hence, a censorship regime is born. A regime based not necessarily on direct regulation of certain channels, programs or content, (although that might be the end result), but instead an indirect censorship regime based on “regulation by raised eyebrow,” in which policymakers provide informal feedback to MVPDs regarding what they’d like to see included in any “family-friendly” tier.

In the end, neither Congress nor the Commission has the legal authority to censor programming that appears on MVPD networks. Cable and satellite television are not licensed to operate "in the public interest" and, therefore, cannot be subjected to the same sort of indecency regulatory scheme that covers broadcasters. But a la carte regulation or "themed tier" mandates might force this question in the courts and lead to protracted legal battles that will benefit neither industry nor consumers.

VI. By What Right?

In closing, it goes without saying that "By what right?" philosophical questions are rarely raised in most regulatory proceedings, but there is a good reason to ask such a question in this matter. Namely, by what right does anyone in government decide how cable or satellite television services—which remain a luxury item and not a birthright entitlement—get priced or packaged in this country?

If enough citizens complained about the bundled laces in shoes or bundled tires on cars or the sports sections bundled in their local newspapers, would that be enough to justify government action to remedy such a non-crisis? The same principle holds for the case of MVPDs and video programming services. Just because a certain number of consumers don't like a particular business model does not give the government license to upend an industry's private business arrangements and substitute a grand industrial policy scheme in the name of "consumer choice."

Moreover, when it comes to consumer choice, MVPD providers have given today's consumers choices that were unimaginable just a generation ago. Apparently, today's generation has lost sight of what has been put at their disposal and many have come to believe that they can call upon government to now carve up existing channels to give them access to programming on any terms they choose; damn the consequences. If policymakers really want to be bold, why not just skip a la carte for channels and instead jump to the ultimate consumer empowerment scheme: a la carte for individual programs. Personal video recorders (PVRs) are already doing this for us in a sense, but policymakers could certainly take steps to preemptively make this the law of the land.

Hopefully, lawmakers understand how such a move would negatively impact existing advertising streams, which hold down per-program costs. And the results would be potentially devastating for traditional program developers since, again, many individual programs only get funded because they are cross-subsidized by other more successful programs owned by the same parent company. A pure program-based a la carte mandate world would leave many niche programs struggling to survive. This logic applies equally for channel-based a la carte regulation. It too would sink many niche channels or networks, which only survive currently because they are cross-subsidized by other channels owned by the same parent, or because bundling in certain tiers helps them attract more advertising dollars and hold costs down.

In conclusion, a la carte regulation is a classic example of the triumph of good intentions over good economics. While proponents may have the best interests of consumers in mind, they seemingly have little regard for the consequences of their proposed regulatory solution. Rising marketplace competition will likely induce experimentation with a la carte business models in coming years (among other pricing and packaging schemes). Government-mandated a la carte regulations, by contrast, will preempt such marketplace experimentation and potentially leave us all worse off than we are today.

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